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Comments by the American Council on Gift Annuities (ACGA) on the Proposed Regulations on Exchanging Property for a Private Annuity

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Public hearing. ACGA wishes to present oral comments at the hearing scheduled for February 16, 2007. Conrad Teitell, ACGA's legal counsel, will be accompanied by [name and title of National Salvation Army officer to be inserted].

Submission. Along with an original and eight copies of these comments are a signed original and eight copies of the outline of the topics to be discussed at the hearing and the time to be devoted to each topic.

These comments are submitted in response to the Treasury's and the IRS's request: "Existing regulations in §1.1011-2 govern the tax treatment of an exchange of property that constitutes a bargain sale to a charitable organization (including an exchange of property for a charitable gift annuity). Example 8 in section 2(c) of those regulations provides that any gain on such an exchange is reported ratably, rather than entirely in the year of the exchange. **This notice of proposed rulemaking does not propose to change the existing regulations in §1.1011-2. However, comments are requested as to whether a change should be made in the future to conform the tax treatment of exchanges governed by §1.1011-2 to the tax treatment prescribed in these proposed regulations.**" [Emphasis supplied]

Had the proposed regulations *actually* treated the exchange of property for a charitable gift annuity in the same way as prescribed in the proposed regulations for the taxation of private annuities (instead of *merely* asking whether a future change should be made), the Treasury and the IRS would have been inundated with comments from charitable organizations giving reasons why the long-standing rules governing charitable gift annuities should not be changed. Thus silence should not be

construed as acquiescence to—and lack of interest in—any future change in the rules governing charitable gift annuities.

About the American Council on Gift Annuities (formally the Committee on Gift Annuities). ACGA, formed in 1927, is an IRC §501(c)(3) organization described in IRC §170(b)(1)(A)(vi). ACGA's board of directors and its legal counsel are all unpaid volunteers.

ACGA is sponsored by 1300 colleges, universities, religious organizations, social welfare charities, healthcare organizations and environmental organizations. Most of ACGA's sponsors have planned giving programs that include charitable gift annuities. A list of the sponsors is "Attachment A" to this statement.

For over 79 years, ACGA has promoted responsible philanthropy through actuarially sound gift annuity recommendations, quality training and the advocacy of consumer protection. ACGA's sponsors are encouraged to work with regulators and legislative bodies to assure protection for the donating public. Charitable gift annuities long antedate charitable remainder annuity trusts and charitable remainder unitrusts. According to ACGA historian Charles W. Baas, the first gift annuity was a gift by Joseph Keith of Massachusetts to the American Bible Society in 1843. It is understood that both Yale and Princeton had even earlier gift annuities.

Executive summary. Charitable gift annuity donors, typically of modest means, create their annuities to make charitable gifts and generally to supplement their retirement income. Without taking a position on the appropriate tax treatment of the private annuities covered by the proposed regulations, ACGA emphasizes that charitable gift annuities are not created under sophisticated tax plans designed to transfer assets to family members at reduced or no gift or estate tax cost—or to pass untaxed appreciation on to family members. If the Treasury and the IRS were to change their position in the proposed regulations and apply the immediate recognition of capital gain rule to the transfer of appreciated property for a gift annuity (rather than recognizing the gain ratably over the annuitant's life expectancy), donors would be greatly discouraged from creating charitable gift annuities—to the detriment of the charitable organizations and the individuals served by those organizations. Many gift annuity donors are serial givers. They make additional gift annuity contributions over the years. Thus existing and new donors would be inhibited from making gift annuity contributions.

Life-income arrangements available to wealthier donors that enable capital gains to be recognized over a number of years (e.g., a charitable remainder annuity trust) are impractical—because of administration and investment costs—for gift annuity donors whose individual gifts are modest. A huge number of small gifts, however, enable many charities to carry out their mission. An installment sale—often available to the taxpayers at whom the new private-annuity-capital-gain treatment is aimed—isn't available to gift annuity donors because at most only 3.6 percent of property used to fund gift annuities (according to a recent ACGA survey described below) would qualify for installment sale tax treatment.

Requested action to be taken by the Treasury and the IRS. The statement in the proposed regulations that charitable gift annuities are excluded from the proposed new rules for the tax treatment of private annuities should be confirmed in the final regulations.

Size of charitable gift annuities, charities offering them, types of funding assets and profile of donors. The most-recent survey of charitable gift annuities was conducted by ACGA in 2004. A copy of the survey is "Attachment B."

Survey highlights:

- 67.4 percent of all gift annuity contributions consist of cash and 29 percent consist of publicly traded securities. Only 3.6 percent were funded with other assets.
- The median size of gift annuities was \$28,027, though the average size was higher, \$59,926. The discrepancy between the median and average size results from a number of larger annuities. But even the average size is minuscule when compared to the private annuity transactions at which the proposed regulations are aimed.
- The median and average size of gift annuities varies considerably among charities. Gift annuities issued by social service and religious charities continue to be the smallest in size while those issued by health organizations, public colleges/universities, and environmental organizations exceed the average.

Organization	Median	Average
All charities	\$ 28,027	\$ 59,926
Private College/University	31,667	56,556
Public College/University	50,000	66,688
Hospital/Healthcare	30,000	118,018*
Social Service	24,633	31,813
Arts	31,200	44,332
Environmental	28,065	57,878
Religious Organization	25,000	33,619
Community Foundation	33,333	56,291
Other	26,333	44,269

*This unusually high number may have resulted from a few very large annuities established by some hospital/healthcare institutions that responded to the survey.

- The “residuum” realized by charities at the termination of annuities was 65.6 percent. The residuum is the portion of the initial contribution for a gift annuity remaining for the charity at the death of the annuitant(s). ACGA’s recommended rates, based on certain assumptions about mortality, expenses and investment return, are designed to result in a 50 percent residuum for the charity. According to the 2004 survey, the residuum for the charity was much higher than the 50 percent target. The residuum was 65.6 percent. Gift annuity rates are deliberately lower than commercial rates to assure significant charitable gifts.
- The average age of annuitants at the time of funding was 78.1 years.
- About 55 percent of annuitants of new annuities are female.
- The most common minimum amount required for a contribution for an annuity is \$10,000 and the next most common minimum amount is \$5,000.
- The number of charities issuing gift annuities continues to increase. Nearly one fourth of charities (24 percent) started gift annuity programs within the past five years (since ACGA’s prior national survey).

Survey's conclusion. The 2004 Survey of Charitable Gift Annuities reaffirmed the growing popularity of the charitable gift annuity among donor/annuitants and a wide range of charities. The findings also underscore the security and practicality of this time-tested gift as a means by which donors can simultaneously realize both philanthropic and retirement goals, and by which charities attract vitally needed resources for their work.

Tax treatment of capital gains on funding gift annuity with appreciated property—background to put current rules, which shouldn't be changed, into context. After passage of the Tax Reform Act of 1969, it wasn't clear whether the new bargain sale rules of section 1011(b) applied to charitable gift annuities. (Under section 1011(b)—enacted by the '69 Tax Reform Act—the donor on a bargain sale of property to a charity must allocate the property's basis between the sale portion and the gift portion and generally recognize the gain attributable to the sale portion.)

In October 1970, John S. Nolan, Deputy Assistant Secretary of the Treasury for Tax Policy, stated at a University of Pennsylvania tax conference: "Another interesting problem is whether the new bargain sale provisions of section 1011 (b), requiring an allocation of basis between the gift portion and the sale portion of the transaction, apply to charitable gift annuity transactions. In these transactions, the taxpayer donates property to a charitable organization in return for the organization's agreement to pay him an annuity. Our tentative position is that section 1011 (b) applies; the transfer of the property is in part an 'exchange' for the annuity."

On learning of Mr. Nolan's comments, a number of charities wrote to the Treasury urging that charitable gift annuities funded with appreciated property not be subject to the bargain sale rules for these reasons:

- Funding a gift annuity with appreciated property differs from the standard bargain sale because with a gift annuity there is no assurance that the annuitant will live long enough to even recover his or her cost-basis in the property.
- Neither Congress in passing the bargain sale provisions of the '69 Tax Reform Act nor the Treasury in making the bargain-sale-provision recommendations to Congress intended that the bargain sale rules apply to gift annuities. The Treasury's proposals and the congressional committee reports made no reference to funding gift annuities with appreciated property. The legislative history dealt solely with sales of appreciated property to charitable organizations.
- Gift annuities funded with appreciated property are an extremely important source of support for charitable institutions.
- The gift annuity is not the type of gift made by wealthy individuals, but rather by those of modest means.
- The federal government's long-standing policy is to encourage charitable gifts. The courts have continually held that the provisions dealing with charitable organizations and charitable contributions should be broadly construed in favor of charitable organizations and their donors.

Presumably, the ratable rule for gift annuities—in §1.1011-2(a)(4)—was promulgated because Treasury refined its tentative conclusion and in response to the concerns, set forth above, by a number of charities responding to Mr. Nolan's statement about Treasury's tentative decision to treat gift annuities as bargain sales.

In any event, the ratably rule has been the law since 1972; nothing has happened between then and now that would warrant a change in that long-standing rule.

The capital-gain-ratably rule for gift annuities is narrowly defined. The donor must be the sole annuitant in a one-life annuity and one of the annuitants in a two-life annuity. Further, the annuity must be nonassignable. The charitable gift annuity is not a fancy tax scheme. There have been no abuses. Accordingly, the Treasury's and the IRS's exclusion of charitable gift annuities from the proposed rules governing private annuities should be confirmed in the final regulations.

How charitable gift annuities differ—are worlds apart—from the private annuities covered in the proposed regulations. ACGA takes no position on whether the rules governing private annuities should be changed. However, ACGA does point out that the tax and financial motivations for donors making charitable annuity gifts differ significantly from those involved in private annuities:

- The Treasury and the IRS in the proposed regulations state that they “have learned that some taxpayers are inappropriately avoiding or deferring gain on the exchange of highly appreciated property for the issuance of annuity contracts. Many of these transactions involve private annuity contracts issued by family members or by business entities that are owned, directly or indirectly by the annuitants themselves or by family members. Many of these transactions involve a variety of mechanisms to secure the payment of amounts due under the annuity contracts.” The foregoing doesn't apply to charitable gift annuities.
- Private annuities often involve the transfer of real estate; not so for charitable gift annuities. According to ACGA's 2004 survey (“Attachment B”), gift annuities are funded 67.4 percent with cash, 29 percent with publicly traded securities and only 3.6 percent with other assets.
- Private annuities are often designed to step up the basis of the transferred asset in the hands of family members; not so for charitable gift annuities.
- Many private annuities are intended to pass on any appreciation subsequent to the transfer for the annuity to family members without any gift or estate tax. For charitable gift annuities, any subsequent appreciation benefits the charitable organization—not the donor or his or her family.
- Private annuities are often recommended by estate planners to individuals in poor health with the expectation that they won't survive their normal life expectancy, thus freeing family members from making payments; not so for charitable gift annuities. Indeed, according to a 2001 mortality study by ACGA, charitable gift annuitants had a longer life expectancy than annuitants of commercial annuities. That study, updated in 2005 by Donald Behan and Bryan O.Clontz at the request of the Society of Actuaries, confirmed ACGA's 2001 study.

Motivation of the charitable gift annuity donor differs vastly from that of the individual who is involved in a private annuity transaction. The gift annuity donor's prime motive is to make a charitable gift—not to reap the benefits of a sophisticated tax plan. Although the income tax charitable deduction reduces the out-of-pocket cost of the gift, the donor would still be much better off financially by not making the annuity gift. The tax savings, in fact, enable many donors to make larger gifts than originally imagined. Further, many charitable gift annuity donors take the standard deduction and for them there is no charitable contribution deduction tax savings at all.

A change in the current rules allowing gift annuitants to report the capital gain ratably over life expectancy would discriminate against donors of modest means who make smaller life-income gifts. An individual who makes a larger charitable life-income gift using appreciated property and who wants fixed annual payments, can and generally does create a charitable remainder annuity trust (CRAT) under section 664(d)(1). There is no capital gain on the transfer of appreciated property for a CRAT. Nor is there capital gain to the donor or the trust if the trust sells appreciated transferred assets and reinvests them. The capital gain is taxable to the recipient over his or her lifetime only to the extent it is deemed distributed under tier two of the four-tier provision of section 664(b).

For the vast majority of gift annuity donors (the median size gift annuity is \$28,027 and the average size is \$59,926), a CRAT is not feasible because of the cost of administering a small separately invested fund. And those costs would, in effect, come out of the charity's remainder-interest gift. The administration and investment expenses would reduce the trust principal, not the fixed dollar amount paid to the CRAT's recipient. Charitable gift annuities are generally pooled by the charity and thus administration and investment costs are kept to a minimum. And unlike the CRAT where the charity has to wait for its gifts until the life-income interest terminates, some charities (depending upon state law and individual practices) use the gift portion (amount transferred minus actuarial value) right away for their charitable work.

The installment sale under section 453 is not an alternative for the gift annuity donor. The Treasury and the IRS in their notice of the proposed regulations state: "In section 453, Congress set forth rules permitting the deferral of income from a transaction that qualifies as an installment sale. Taxpayers retain the ability to structure transactions as installment sales within the meaning of section 453(b) provided the other requirements of section 453 are met." As noted earlier, according to ACGA's 2004 survey, only 3.6 percent of gift annuities are funded with assets other than cash or publicly traded securities. The balance are funded: 29 percent with publicly traded securities and 67.4 percent with cash. Since installment sale treatment is not available for marketable securities, the installment sale isn't an option for the gift annuity donor. And even if it were, the donor who wants to make a charitable gift and supplement retirement income wants the income over his or her *entire* life (not possible with an installment sale).

Conclusion. The final regulations should confirm the proposed regulations and exclude charitable gift annuities from the proposed regulations' rules for private annuities. Any change in the long-established rules governing the transfer of appreciated property for a charitable gift annuity would be for the Congress to make, not the Treasury and the IRS.

Thank you for this opportunity to give the American Council on Gift Annuities' views. For additional information or amplification please contact: Conrad Teitell, Cummings & Lockwood, Six Landmark Square, PO Box 120, Stamford, Connecticut, 06904-0120; phone: (203) 351-4164; fax: (203) 351-4535; e-mail: cteitell@cl-law.com.